MASS. GC6. PA11/2: M38

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Preliminary Report

THE MASSACHUSETTS TAX GAP

February 15, 1995

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Summary of Findings

- The Massachusetts tax gap is potentially greater in scope than the tax gap that exists at the federal level. The Department of Revenue ("DOR") has failed to adequately monitor the Massachusetts tax gap.

- The federal tax gap and a reduced federal audit presence have major implications for Massachusetts and DOR.

- The House Post Audit and Oversight Bureau estimates that the Massachusetts tax gap is in the range of $1.5 - $2.0 billion dollars.

- Since FY'91, DOR audit assessments have dropped as the number of DOR auditors has declined.

- DOR has imposed the greatest staff reductions in the multistate audit section where each auditor generates more than $1 million dollars in assessments per year.

- Unreported income, corporate apportionment questions, unreported cash transactions, domicile issues, dealer plate registrations, and a criminal tax fraud are just some of the key components of the Massachusetts tax gap.

- DOR has placed additional resources in administration and technology while imposing significant reductions in auditing and enforcement.

- The Bureau found the potential for substantial non-compliance attributable to out-of-state contractors and vendors.

The Underground Economy is Alive and Well. Tax-compliance and the Need for Audit.

In 1993, the House Post Audit and Oversight Committee (the "Committee") conducted a performance review of the Massachusetts Department of Revenue ("DOR") and the issue of budget cutbacks, downsizing and the closing of district offices. As part of that review, the House Post Audit and Oversight Bureau (the "Bureau") focused its efforts on the cost effectiveness of auditing and the extent to which the number of auditors affected compliance with the tax laws. The Bureau found that there was a positive correlation between the number of auditors and compliance. The Bureau also found that non-compliance rates and tax evasion both nationally and at the state level, are major problems that significantly reduce governmental revenues.

This report examines the scope of the Massachusetts tax gap (the difference between taxes owed and actually collected from individuals and businesses) and the efforts of the DOR since FY'91 to deal with that problem. This report also focuses on the scope of the national tax gap and its impact on Massachusetts non-compliance problem. The Bureau notes that in the face of uncertain economic times and in the midst of calls for tax cuts, the goal of a high level of compliance with the Massachusetts tax laws is critical to the support of state programs and overall fiscal stability. The Bureau found, however, that DOR has steadily cut its auditing staff since FY'91 and has failed to adequately monitor the tax gap and the effect that reductions in audit staff have on compliance.

I. Scope of the Problem - The Federal Tax Gap

In May of 1994, the United States General Accounting Office ("GAO") found that

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"the gross income tax gap is large and has grown from $76 billion in 1981 to $127 billion in 1992." [1] While somewhat imprecise, these estimates provide useful indicators of the levels of taxes which are not voluntarily paid as well as a general estimate of the composition of the tax gap.[2]

The GAO report noted that of the $127 billion gross tax gap in 1992, $94 billion was attributed to individuals and $33 billion was attributed to corporations who either failed to file returns or report income subject to tax. Across all individual taxpayers the largest part of the tax gap arose from unreported income - $63 billion. Overall, IRS estimated that taxpayers voluntarily paid 82% of their income tax liabilities.[3]

The report noted that the tax gap has grown despite federal legislation aimed at closing the tax gap. The GAO also noted that IRS major enforcement activities have not grown over the past decade. Audits of corporations have decreased from 5 percent in FY'81 to less than 3 percent in FY'92. During the same period, audits of individuals decreased from 1.8 % to less than 1 percent.[4] It is not surprising that the federal tax gap has continued to grow in the face of a diminishing IRS commitment to auditing.

The sheer size of the tax gap estimates are staggering. Not only do these figures raise serious concerns about lost federal dollars, but they represent a major source of concern for state tax administrators as well. Many states "piggy-back" on the federal income tax

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[1] **Tax Gap Many Actions Taken, But a Cohesive Compliance Strategy Needed** (GAO/GGD-94-123)

[2] Id. at 3.

[3] Id. at 4.

[4] Id. at 5.

determinations in computing the amount of tax due that particular state. States also indirectly rely on IRS audits and enforcement. A diminishing federal audit presence has major implications for the states.

II. Impact for Massachusetts

What is the level of the non-compliance problem in Massachusetts?

The Bureau's review found that in recent years DOR has failed to monitor tax compliance adequately. According to DOR, the last time the agency produced a tax compliance report was in 1987.

DOR was asked by the Bureau if it had made an analysis of the tax gap similar to what IRS had done, and how much state revenue would be lost if the federal figures were accurate. The DOR Commissioner responded that, "**[t]he Department has not made a similar analysis. The IRS study took three years to complete, at considerable expense. Only the IRS has the resources for an effort of this magnitude; we devote our compliance research to identify pockets of non-compliance that can produce productive audit leads or non-filer projects.**"[5] (emphasis added)

The Bureau questions whether the Commissioner is accurate in stating that only the IRS has the resources for an effort of this magnitude. Clearly, DOR was able to produce an estimate of non-compliance in 1987. DOR previously estimated the amount of non-compliance with selected taxes in 1983 to be $640 million.[6] Moreover, re-creating that

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[5]Letter from DOR dated 6/1/94, question #5, Exhibit 1

[6]Mass. Economic Indicators, Vol. II, #10, October, 1987.

IRS study is not the real issue. What is important to determine is to what extent IRS estimates and analysis have significance for tax compliance in Massachusetts.

The Bureau believes that it is critical for DOR to analyze closely the IRS' estimate of the tax gap. As can be seen from the GAO report below, unreported income accounted for $62.7 billion of the federal tax gap in 1992. This figure has major significance for tax compliance in Massachusetts. If for example the Massachusetts tax gap grew at the same 67% rate for the period measured in the IRS study, the short-fall of Massachusetts taxes collected would easily exceed $1 billion dollars.

Table 1.1[7]

Dollars in Millions

Source of federal tax gap	1981 tax gap amount	1992 tax gap amount	Percent Increase
Individual tax gap	$ 61,900	$ 93.994	51.8
Unreported income	40,433	62,759	55.2
Sole proprietors	18,714	30,173	61.2
All other income	21,719	32,586	50.0
Overstated deductions	7,449	8,081	8.5
Individual nonfiler	5,231	10,233	95.6
Individual remittance gap	8,300	11,400	37.3
Math errors	487	1,521	212.3
Corporate tax gap	14,066	33,135	135.6
Small corporation	4,461	6,999	56.9
Large corporation	8,638	23,716	174.6
Others	167	420	151.5
Corporate remittance gap	800	2,000	150.0
TOTAL TAX GAP	$ 75,966	$127,129	67.2 (figures rounded)

Table 1.1: Gross Federal Tax Gap Estimates by Source of Tax Gap for Tax Years 1981 and 1992, in Current Dollars

[7] Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Estimates, IRS Publication 1415 (4-90)

III. The Bureau Found that the Scope of the Massachusetts Tax Gap is Larger than the Federal Tax Gap.

The Bureau found ample evidence to support the idea that Massachusetts has all of the components of the federal tax gap for personal income tax and corporate taxes. The Bureau also found a number of factors that exist on the state level that are not present at the federal level.

According to the GAO report, in fiscal year 1992, $30.1 billion of the federal tax gap was attributed to sole proprietors. Here again the impact for Massachusetts is significant. Sole proprietors, i.e. self-employed individuals who either are underreporting income or not reporting at all are most likely evading both the state and the federal tax system. As a result of the advent of a reliable system of computer matching, it is unlikely that a substantial portion of this problem is made up of individuals who only file or report in one of the two tax systems. The bulk of the tax evaders in this category are evading both systems.

The decline in federal audits has a significant impact on state audits. Because DOR "piggybacks" on federal audits, the reduction of audits at the federal level contributes to the non-compliance at the Massachusetts level. For both personal income tax and corporate excise tax purposes, Massachusetts uses federal gross income as the starting point for the computation of the particular tax.

There are however significant differences between the Massachusetts and federal tax systems that can only increase the scope of the Massachusetts tax gap. The federal tax structure is based in large part on an income tax supported by "voluntary compliance" in the form of withholding at the source. The Massachusetts income tax and the Massachusetts

corporate excise taxes while based on the federal gross income figure, have significant statutory deviations from the federal system in the way each tax is computed. The myriad of credits, exemptions and exclusions that exist at the state level are in large part in addition to those allowed under federal law. Each one of these statutory deviations creates an "audit issue" or a potential area of abuse or non-compliance.

More significantly, unlike the federal tax scheme which is predominately an income tax, Massachusetts relies on a number of other special excise taxes in addition to the personal income tax, all of which create additional opportunities for tax evasion. The Massachusetts sales tax, meals tax, and room occupancy excise tax are not comparable to any tax that exists at the federal level. These taxes are computed, based on gross receipts and are collected and remitted by private vendors on behalf of the Commonwealth. These taxes are derived in large part from cash transactions. It is well established that there is significant potential for tax evasion in cash businesses where others collect the tax on behalf of the government. Because Massachusetts receives over $2.3 billion in sales taxes collected by trustees, the potential for substantial evasion is financially significant.

IV. Recent DOR Policies May be Contributing to an Increasing Tax Gap.

The Bureau found that since FY'91 DOR has placed more resources in administration and technology apparently at the expense of compliance and auditing. The Bureau seriously questions this reallocation of resources in light of its findings about the Massachusetts tax gap.

The DOR's 1987 Compliance Report concluded that "tax evasion is less likely if

enforcement levels are high and visible and if the penalties for evasion are severe".[8] In FY'90, DOR's Annual Report touted the state's 100% criminal conviction rate for tax evaders and noted "delinquent tax collections exceed half a billion dollars".[9] These statements emphasize strict enforcement and are in stark contrast to recent testimony and statements made by the Commissioner and other DOR spokesmen. In February 1993, the Commissioner testified before the Committee that he felt tax audits were intrusive.[10] He also testified that "...at some point, you reach a point of diminishing returns (in doing audits)...because you begin to harass people".[11]

A DOR spokesman was quoted in the Boston Globe as saying "the Weld Administration has decided not to go after nannies. The unpaid nanny tax is not a burning issue here in the Bay State." This public statement by a DOR official was in bold contrast to the IRS which stated in the same article that "it (IRS) does not condone any form of tax evasion or failing to file." These statements by the Massachusetts officials are troubling to the Bureau and may be indicative of a lax attitude toward audit and enforcement.

DOR maintains that its recent focus has been to try to assist taxpayers in complying with the tax laws by facilitating filing and prompting more "user friendly" types of systems. The Bureau does not believe that assisting taxpayers and auditing are mutually exclusive. While ease of administration and taxpayer assistance are important parts of voluntary

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[8]DOR's 1987 Compliance Report, page 4.

[9]DOR's FY'90 Annual Report, page 1.

[10]February 23, 1993 House Post Audit and Oversight Committee Public Hearing Transcript, page 22.

[11]Id. at 21.

compliance, the fact remains that audits and enforcement, are important tools of tax administration.

While the DOR Commissioner stressed that audits could reach a point of diminishing returns he provided no insight into what that point was. His statements before the House Post Audit and Oversight Committee were inconsistent. He stated at one point during the hearing: "It's not clear that (adding more auditors) would bring in more revenue".[12] Yet the Commissioner testified earlier in the same hearing that "voluntary compliance is critically dependent on the fear of enforcement." [13] In the same hearing, the Commissioner stated, "[a] reduction in auditors does not necessarily mean the Commonwealth is losing money".[14] Yet in a June, 1993 letter to the Senate Chairman of Ways and Means, the Commissioner noted that because of layoffs at DOR since 1989, "collection of delinquent taxes has suffered"; and in budget submissions to the legislature identified specific revenue losses attributed to a reduction in audit staff. DOR's own budget cut projections in FY'93 also undercut the Commissioner's claim that cuts in auditors will not cost the Commonwealth money. According to those documents: a "Target B" reduction of $10.4 million in the DOR's Tax Administration account would cut the New England Audit Bureau by 58 positions, resulting in a $19 million dollar loss of revenues to the Commonwealth. (emphasis added)

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[12]Id. at 26.

[13]Id. at 23.

[14]Id. at 13.

The Commissioner also testified before the House Post Audit and Oversight Committee that he did not believe an analysis of the effectiveness of audits could be done.[15] Yet, in 1992, DOR's own consultant which was hired to analyze the impact of budget cuts noted: "There does appear to be a direct correlation between a reduction in the number of auditors and the total dollar amounts of assessments of taxes owed made annually. It therefore appears possible that audit assessments for fiscal year 1993 will be decreased as a result of the proposed cuts."[16]

The Bureau disputes the claims that the effectiveness of audits cannot be measured or quantified . DOR routinely submits per-auditor statements of audit assessments to the Legislature. At the House Post Audit and Oversight Committee hearing, the DOR Commissioner himself testified that each auditor in FY'92 generated $500,000 in assessments, yet cost the Commonwealth only $67,000 in salary and benefits.[17] Other figures computed per auditor and submitted to the Ways and Means Committee by DOR for later years, indicated even higher levels of assessments.

The Bureau does not believe that DOR is in danger of reaching the point of diminishing returns in terms of auditing. Given the substantial amounts of audit assessments which continue to be generated by each auditor - well over $700,000 in some DOR correspondence to the legislature - it is fair to say that point has yet to be reached. Moreover, given the scope and magnitude of the federal tax gap, it could hardly be argued

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[15]Id. at 17.

[16]Mass. DOR Assessment of Proposed Cost Reduction Targets, April 1992, Coopers & Lybrand.

[17]Id. at 20.

that Massachusetts, with no comparable analysis having been done for at least 7 years, could be in a position to make a decision that less auditors is preferable to more auditors.

The Bureau has every reason to believe that the tax gap in Massachusetts is at least as significant a problem for DOR as it is for the IRS. Because it is much more likely that individuals and sole proprietors are not reporting taxable income to either the state or the federal government, the rate of non-compliance in payment of personal income taxes is at least as great as the 18% non-compliance rate at the federal level. If Massachusetts has a compliance problem similar to that of IRS, the effect of tax gap for just the personal income tax approaches $1 billion dollars.

A substantial portion of Massachusetts' tax revenues are collected by non-governmental entities (trustees) which compute, collect and pay over taxes paid by others. Businesses with significant cash transactions such as bars, barber shops, beauty salons, restaurants, florists, retail stores, roadside stands and many, many, others provide significant tax evasion opportunities. The lower the audit presence in the retail sales and meals tax area, the greater the potential for tax evasion.

The Bureau's review of DOR's recent de-emphasis on auditing reveals a very limited perspective on the tax gap and enforcement. The Bureau's review indicates that the DOR Commissioner in recent years has placed a great emphasis on technology and computerization with a corresponding de-emphasis on personnel, field audits, and enforcement. The Bureau reiterates its claims that technological enhancements, audit and enforcement are complementary, and are not mutually exclusive. The Bureau finds that in DOR's case it is, in fact, counter-productive to diminish staff resources at the same time technological

advancements are being made. Individuals and support personnel are vital to augment the enhancements provided by technology.

The Bureau believes that computers provide valuable tax enforcement tools in the form of matching programs of federal and state files. Computer matches of 1098, 1099, and W-2 forms, as well as sharing other federal tax information and federal audit workpapers provide valuable and cost-effective compliance monitors. Unfortunately, computers cannot replace field audit presence in many very substantial areas. The areas identified below are just some of the very real tax evasion schemes that contribute to the state tax gap.

A. The Corporate Shell Game

Apportionment of income by multijurisdictional corporations is a major financial area that requires significant audit presence. Large corporations that are taxpayers in multiple jurisdictions must apportion their income under statutory formulary apportionment methods. Because formulary apportionment requires arbitrary assignments of a corporation's property, payroll, and sales to particular jurisdictions, audit and field verification are critical components of tax compliance. Computers provide little assistance in this area because corporations can artificially assign factors to particular jurisdictions with little chance that computer verification could detect the variance.

Moreover, the assignment of income and less than arms length transfer pricing between affiliated corporations pose significant tax compliance challenges. The Bureau found that the licensing of patents and other intangibles, the use of holding companies incorporated in tax havens or low-tax jurisdictions, and non-arms length transfers of goods and services to foreign subsidiaries, provide easy and effective ways for large corporations to avoid state

taxes. While the IRS has substantial transfer pricing issues on the international level, DOR is faced with the same problems with corporations that do business in most states and foreign countries. These sophisticated transfer pricing and holding company tax schemes are not susceptible to detection and review through computers. Field audits and information sharing by taxing authorities are critical to compliance efforts. The accounting ledgers and computer records of the companies in and of themselves provide little evidence of the fair market value of the goods and services transferred.

B. Domicile

Other examples of the problems of tax enforcement outside the reach of computers involve domicile and corporate nexus (i.e. jurisdiction to tax). Individuals who were domiciled in Massachusetts, but who claimed another state as their domicile may be able to avoid capital gains taxes or estate taxes. According to a former DOR commissioner, "[e]ven though Massachusetts is aggressive in enforcement in this (domicile) area, I think it is missing substantial amounts of money".[18] As DOR's General Counsel revealed "[i]t takes a tremendous amount of detective work before we feel confident enough to go after people." (for domicile cases) The General Counsel's statement highlights the fact that enforcement in this domicile area involves detective work, the kind of work in which computers have a limited role.

In addition, while most domicile cases can be handled in a civil context, there are tax evasion cases where a clear criminal motive can be proved and a criminal conviction can result. The Attorney General was recently successful in obtaining a criminal conviction for

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[18]March 8, 1994 Boston Globe article "No Place Like Home".

tax evasion against a former high ranking official in the Massachusetts Corrections Department who had claimed New Hampshire as his domicile. The criminal investigation was initiated after a news account in the Lawrence Eagle Tribune raised questions about the defendant's domicile. These reports led to an investigation by the DOR and the state Attorney General's office which uncovered an elaborate scheme to evade state taxes. The Commonwealth was able to prove that the defendant lived year round in Boston rather than in New Hampshire. DOR auditors did a full field audit involving all of the books and records of the defendant including utility bills, checking accounts and a number of other records which established his Massachusetts domicile. This audit was very labor intensive and required a substantial commitment of time by the auditors.[19]

C. Massachusetts Jurisdiction to Tax of Foreign Corporations/Corporate Nexus

Many large corporations that routinely do business in Massachusetts do not necessarily file tax returns in Massachusetts. Because Federal law (P.L. 86-272) prohibits a state from imposing a corporate excise tax on a company that only makes sales into a particular state, the issue of what corporate activities subject it to corporate tax are substantially audit issues. A FY'90 DOR case highlighted this issue. During FY'90, DOR found that **Mercedes Benz of North America, Inc.** had not been filing returns in Massachusetts despite making substantial sales and conducting other activities which subjected it to Massachusetts corporate excise tax. After a full field audit, DOR was able to recoup more than $9.1 million in back taxes. This audit was initiated by DOR's New York office and was part of a larger audit of foreign

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[19]The House Post Audit & Oversight Bureau had also referred the news articles in the Lawrence Eagle Tribune to DOR requesting a domicile field audit.

automobile manufacturers. This investigation netted the Commonwealth nearly $20 million in delinquent taxes.[20] Cases involving Massachusetts' jurisdiction to tax a foreign corporations are audit driven and rely only in minor ways on the use of technology.

D. Non-Filing - Non-Reporting

The Bureau has also reviewed a number of other areas where significant tax compliance problems currently exist. The enforcement of the Massachusetts prevailing wage laws indicates there are significant problems with employees paid "under the table" on construction jobs. The Bureau has encountered instances where duplicate ledgers and records were maintained for the purpose of avoiding prevailing wage laws. These activities fostered significant unreported taxable income and tax evasion, as several of the employees were found to have been non-filers for Massachusetts income tax purposes.

The Bureau also noted a high level of income simply not reported from illicit and illegal activities. As part of the Bureau's review of fraudulent motor vehicle licenses, the Bureau noted that millions of dollars of income are derived from credit card fraud and forgery. Mastercard alone projected $420 million in losses eligible for tax write-offs in 1994 due to credit card fraud. Mastercard projected $6.4 million of those losses in Massachusetts.[21] Income from these illegal activities escapes taxation in almost all cases.

E. Dealer Plates/Repair Plates

The Bureau found repeated and continuing incidents of tax evasion through illegal and improper use of dealer plates and repair plates. While some positive steps have been made

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[20]DOR FY'90 Annual Report

[21]Mastercard International Inc. preliminary figures for 1994.

by the Registry of Motor Vehicles ("RMV") in reducing the abuses of repair plates, the effectiveness of new policies is contingent on vigilant enforcement.

In the area of dealer plates, the evasion of sales tax continues. DOR has disbanded the sales tax unit for dealer plates. The RMV has done little to promote enforcement in this area. In some cases the RMV has actually discouraged enforcement efforts by promulgating guidelines that place unreasonable burdens on the enforcing authorities. RMV's policies allow personal uses of dealer plates that far exceed the language of the statute. RMV's most recent issuance of dealer plate identifying marks have made the decals extremely light, making them even more difficult to identify. Lax enforcement policies by the RMV in these areas frustrate legitimate tax enforcement efforts.

Dealer plate registrations issued under Massachusetts General Laws Chapter 90 Section 5 continue to provide users with an opportunity to successfully evade sales and excise taxes due on motor vehicles operated in the Commonwealth. Although the RMV's decal program has improved the collection of sales taxes on repair plates, it has failed to eliminate the potential for abuse within dealer plates. The Bureau found that Massachusetts General Laws Chapter 90 Section 5 and the corresponding regulations, do not provide any means of insuring that sales and excise taxes are paid on vehicles operated with dealer plates. Vehicles held for resale by a car dealer are exempt from the decal program.

Prior to 1993, DOR audited car dealerships in a systematic manner through the dealer/repair unit of the Determinations Bureau. The dealer/repair Unit maintained a visible audit presence in order to improve and maintain voluntary tax reporting by car dealers. Various dealer/repair initiatives resulted in substantial collection of taxes which, absent DOR

audit, would have remained uncollected. In 1990, DOR and the RMV utilized a joint effort to address sales tax evasion through Section 5 registrations. According to a December 3, 1990 memo from the Commissioner of Revenue and the Registrar of Motor Vehicles to the Governor, the joint effort resulted in the collection of $5.3 million dollars in delinquent sales taxes. The investigation uncovered an abuse and delinquency rate of 50%.

According to DOR documentation, field audits of car dealerships cannot simply be replaced with computer programs aimed at obviating the need for auditors. Field audits of car dealerships are: "...labor intensive, complex and time consuming." [22] There is a substantial number of cases for which field audits would result in additional tax revenues.

> **"Our reviews over the past three years have turned up thousands of motor vehicles with special plates used in a manner as to defeat the taxes lawfully owed."[23]**

The Bureau found no evidence that the RMV has substantially reduced abuse in this area. In fact, some RMV actions appear to facilitate the evasion of taxes due on vehicles operated with Section 5 registrations. One DOR official expresses concerns about limitations in the RMV's ability to administer motor vehicle sales tax laws noting:

> **"...The Registry has no developed expertise in determining whether or not a tax has been paid or ought to be imposed. That expertise lies in the**

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[22]Determinations Bureau Chief memo dated 7/24/91.

[23]Determinations Bureau Chief memo dated 7/24/91.

Department of Revenue and the power to determine whether appropriate taxes have been paid should rest with the Commissioner of Revenue." [24]

Absent a significant audit presence by the DOR, evasion of sales and excise taxes in the dealer plate area will continue and flourish.

F. Financial Transaction Fraud

The underground economy and growth of illegal source income continue to be major sources of problems for tax officials. For example, check fraud costs banks billions of dollars on an annual basis. According to the National Association for Bank Security, the annual check fraud cost is $10 billion dollars. Banker's Hotline Newsletter says that 10-12 billion is lost.[25]

G. Independent Contractors Versus Employees

There has been a recent move on the part of several types of businesses to move toward utilization of "independent contractors" as opposed to full-time employees. One example of this is messenger services. Employers can reduce their costs for benefits and insurance by classifying these delivery messengers as independent contractors. From a tax administration point of view, this mis-classification of an employee as an independent contractor means there is no income tax withholding or unemployment taxes collected. Independent contractors have become a significant problem for taxing authorities. IRS estimates that the misclassification of employees as independent contractors costs the Treasury $2 billion in revenues annually.

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[24]DOR memo of 7/29/91

[25]Banker and Tradesman, February 1, 1995, page 7.

H. Barter

Utilization of barter or barter exchanges of services can also be a contributor to the tax gap. Under the Barter system, individuals or organizations form formal or informal associations to exchange services such as accounting, legal, financial planning and a number of others. Because these services are exchanged with no cash changing hands, there is no income reported for tax purposes. There are no estimates currently available on impact of barter on the tax gap.

V. Criminal Enforcement

The Bureau contacted the Attorney General's Criminal Division to determine the scope of the tax evasion problem from the perspective of criminal tax prosecutions. The result of the last 10 years of, criminal tax prosecutions can be summarized below:

1.	FY'84	42 individuals and corporations, $1.25 million in fines.
2.	FY'85	41 new cases, $1.4 million in fines.
3.	FY'87	Tax Prosecution Unit ("TPU") established interagency agreement with DOR. 19 new cases, individuals and corporations.
4.	FY'88	DOR employee charged for fraudulent refund scheme. Former president of Bridgewater State College convicted of fraud and tax violations. 35 criminal tax cases litigated . 21 new cases indicted for tax evasion.
5.	FY'89	Supervisor in DOR pleads guilty to charges of criminal tax fraud and tax evasion following indictments in June and October of 1988. Tax prosecution unit disposed of 49 criminal cases - one case included a corporate fine in the amount of $150,000.

6. FY'92 Tax prosecution unit obtained convictions in 21 cases involving tax evasion and willful failure to file income tax, meals tax and/or sales taxes.

7. FY'93 Obtained convictions in 10 cases and another 18 cases were indicted.

The following is a synopsis of the activities of the TPU in FY'93 (See Appendixes 1 & 2).

8. FY'94 25 New cases (See Appendixes 1 & 2).

The Bureau's review of these criminal cases indicates that it is only the tip of the iceberg. This steady stream of criminal cases involves millions of dollars of sales, meals and withholding taxes that are deliberately withheld from the Commonwealth by the criminal defendants. Other cases chronicled in the appendix of this report indicate the breadth of activities from which individuals and corporations fail to report income, ranging from income derived from an insurance oversight company to bicycle repair shops. The consistency and the magnitude of the flow of these criminal cases indicates that the criminal component of the tax gap is not abating. The nature of these cases highlights again the shortsightedness of the view that computers and technology can be substituted for field auditors. Sources in the Attorney General's office indicated additional field auditors would produce many more of these criminal cases.

VI. Border Tax Issues

The Bureau did a review of border towns in Massachusetts to determine the level of compliance with Massachusetts tax laws by out of state contractors performing construction and other services. In the cities of Lawrence and Haverhill, the Bureau reviewed 11 building permits from contractors or builders who were later found to be non-filers by the DOR. The

amounts on these permits were projected at more than $580,000 in construction work. A substantial number of other contractors who were listed on building permits and other records were not registered for sales or use tax purposes. While some of these businesses and individuals may have had legitimate reasons for non-filing, the large number of non-filers indicates that there may be significant non-compliance in this area.

The Bureau also noted a number of cases where individuals with summer houses in New Hampshire were registering cars in New Hampshire or having items of personal property delivered to their summer or vacation homes to escape the Massachusetts sales tax.

In response to the concerns raised about the registration of cars in New Hampshire that are operated primarily in Massachusetts, the RMV developed a toll free line to deal with the issue (1-800-I-Pay-Tax). According to the RMV, the information obtained from this service was not shared with DOR. Because of RMV's lack of expertise with tax enforcement and the failure to share information with DOR, the Bureau is concerned about the effectiveness of this program.

VII. State Issues

In the course of reviewing state contracts and audit reports, the Bureau found a number of cases where the vendors doing business with the Commonwealth owed taxes. For example, one Department of Mental Health vendor at one point owed the Commonwealth and the federal government over $1.8 million in payroll taxes. The State Auditor's Report on the Commonwealth's Purchase of Service System issued on December 14, 1994 noted several tax issues with state vendors.

- One vendor avoided state and federal income taxes by use of a separate health plan for an employee
- Another vendor was assessed over $73,000 in interest and penalties for failure to remit payroll taxes.
- Other vendors did not report personal use of company vehicles and other fringe benefits.

The State Auditor also issued a report in November of 1994 that indicated that policies and procedures at the Massachusetts Commission Against Discrimination ("MCAD") may have facilitated income tax evasion. The State Auditor conducted an audit of internal controls over the use of advance checking account funds at MCAD. MCAD used the account to pay hundreds of thousands of dollars in wages to private contractors. The State Auditor found that contract employees paid by MCAD had no taxes withheld from their income. Further, MCAD had failed to issue W-2's or 1099 income statements to report contractor earnings. This failure increased the potential for contractor earnings to remain unreported for state tax purposes.

VII. DOR Auditing - Immediate Effect and Multiplier Effect

The Bureau has found substantial evidence that there are large numbers of pockets of tax non-compliance within the underground economy that could be severely impacted by an increased audit presence. The Bureau believes that the Commissioner of Revenue is understating the potential of tax gap and is naive in assuming that computers can address this far reaching and complex problem. A 1984 study commissioned by the IRS indicated that 1 in

5 persons admitted to cheating on their taxes and that 1 in 3 condoned the behavior.[26] The Bureau's examination found substantial information that supported many aspects of the IRS's studies.

In FY'84, DOR made audit assessments of $272 million. In FY'87, assessments per auditor were listed at $793,000. Figures recently provided by DOR indicated audit assessments had dropped to $251,042,521 for FY'93 and FY'94 projected even lower to $229,037,071. This drop in audit assessments is significant especially when considering the fact that computers and other technological enhancements have been added to DOR during the late 1980's and the early 1990's. One logical explanation for the decline in these audit assessments can be found in the significant cuts in personnel in the Audit Division .

The Bureau is concerned about the long term implications for compliance that will result from the decline of both field and desk audit staff. Although some of the figures provided by DOR over the course of time were inconsistent, they showed as a general rule, that the number of tax auditors has declined over the past few years.

In recent years, DOR audit positions have been reduced as follows:

	Auditors as of 6/30/91	**Auditors as of 6/30/94**	**Difference**	**Percent**
New England Audit Bureau	**274**	**244**	**-(30)**	**- (10.9)%**
Bureau of Desk Audit	**83**	**75**	**-(8)**	**- (9.6)%**
Multistate Bureau	**78**	**51**	**-(27)**	**- (34.6)%**

The figures above show that over the last three fiscal years, the number of Multistate auditors was reduced by 34%, representing a much deeper cut than other audit sections. On a

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[26]Yankelovitch, Skelly & White, Taxpayer Attitudes Study Final Report prepared for IRS, 1984.

per capita basis the level of assessments that each multi-state auditor made was $1,372,563, an amount that was substantially higher than either Desk Audit or New England Audit. No rationale or explanation was provided to support this reduction in the Multistate Bureau. DOR's Multistate auditors are located in regional offices outside of Massachusetts. These Multistate auditors conduct field audits of large corporations at their regional headquarters located in Atlanta, Chicago, Houston, Los Angeles, Pittsburgh, New Jersey, and New York.

VIII. Current IRS Actions

The IRS is now in the process of increasing its audit coverage of individual returns. According to IRS personnel, the agency plans to double the number of audits of personal income taxes and plans to increase the number of face-to-face audits in addition to an increase in correspondence audits. Former IRS Commissioner Donald Alexander has urged even greater emphasis on "face to face audits" which he says are the most effective way to improve compliance.

This increase in IRS' commitment to auditing comes on the heels of statements made before the subcommittee on Oversight of the U.S. House Committee on Ways and Means. That testimony revealed that IRS had identified 26,000 fraudulent electronic income tax returns during the first 10 months of 1993 - a 105% increase over 1992 levels. These high levels of fraud are alarming and indicate the need for a further commitment of IRS resources to audit and compliance. These figures also expose the deficiencies in only relying on technology for the collection of taxes.

Recommendations and Conclusions

1. **Conclusion**

The Bureau found substantial evidence of tax evasion and non-compliance with the Massachusetts tax laws. The current research indicates that non-compliance with the tax laws is a major and growing problem.

Recommendation

The Bureau recommends that DOR immediately initiate a study to estimate the magnitude of the state tax gap. The study should focus efforts on the IRS methodology and findings of its most recent study, and DOR should examine the growth of state personal income and the correlation to state income tax revenues. DOR should do a complete review of the components of the underground economy and should coordinate efforts with other state agencies including DOR's own Child Support Enforcement Division.

2. **Conclusion**

The Bureau found ample evidence for the proposition that computers and technological enhancements are only some of the tools in the fight to stem tax non-compliance. The Bureau found substantial evidence that tax evasion on the state level is often not susceptible to detection by computers. The Bureau believes that a significant commitment to field auditors is absolutely essential to sound compliance policy.

Recommendation

DOR should initiate a review of all field and desk audit operations to evaluate which functions need additional audit staff.

3. **Conclusion**

The corporate shell game, intercompany pricing issues, and large sales tax issues mandates an aggressive national presence. The sophisticated corporate excise and sales tax issues that arise with Fortune 1000 companies requires the specialized focus of Multistate unit auditors.

Recommendation

DOR should return Multistate audits to the FY'91 level.

4. Conclusion

Based on current tax collections, IRS figures and growth in Massachusetts personal income, the Bureau estimates that the magnitude of the state tax compliance problem to be in the range of $1.5 to $2.0 billion dollars.

Recommendation

DOR should require an annual study of the problem of non-compliance so that scarce enforcement resources can be targeted toward evolving tax evasion schemes. The Bureau should embark on a full study of non-compliance and should survey the other forty-nine states to obtain the most recent information on the scope of this problem.

* * * *

Appendix 1

Records obtained from the Attorney General's office showed a steady stream of current tax cases. Officials in the Attorney General's office said that field audit was essential to the development of these types of cases.

Excerpts from the Attorney General's FY'93 Tax Prosecution Unit Report

Among the cases initiated or prosecuted to a disposition by the Tax Prosecution Unit in FY'93 are the following:

Conviction of an owner of two sub shops who failed to pay meals taxes he had collected from customers and who subsequently filed false documents with the Department of Revenue. Unpaid taxes totalled $56,000. The defendant was sentenced to serve 89 days in jail and was placed on probation thereafter.

Conviction of a restaurant and sporting goods store owner for failure to pay over $130,000 in meals taxes and sales tax he collected. The Court refused to incarcerate the defendant despite the Commonwealth's sentencing recommendation. However, the defendant received a suspended state prison sentence with probation for 5 years, 2000 hours of community service, and a payment of all unpaid taxes.

Convicted an attorney and municipal official who failed to file income tax returns for several years. The defendant received a suspended sentence and was ordered to pay a fine of $25,000.

Convicted a municipal official on five counts of filing false income tax returns and one count of failure to file a return in connection with unpaid taxes of $38,000. The defendant agreed to cooperate with the Commonwealth in its ongoing investigation and has been ordered to pay a fine of $31,250.

Indicted an individual for 5 counts of aiding and assisting in the filing of false tax returns after he helped a relative prepare and file false tax returns.

Indicted a canteen truck owner for evading and failing to report almost $10,000 in meals taxes, representing meals taxes collected on approximately $200,000 in sales.

Indicted an attorney on 5 counts of failure to file income tax returns. This defendant owed the state over $20,000 in income taxes on earnings of over $400,000.

Indicted a husband and wife for failing to file income tax returns on income over $450,000, earned by their executive recruitment service. These defendants owed over $17,000 in taxes.

In two separate cases, indicted two individuals who reside in Massachusetts but worked for an out-of-state company. These individuals failed to file income tax returns for several years and together owed $11,500 in taxes on income over $270,000.

Indicted a self-employed consultant on four counts of failure to file income tax returns. The defendant owed over $17,000 in taxes on income in excess of $420,000.

Indicted a used car dealer for filing false income tax returns, based on evidence that he failed to report approximately $60,000 of additional income during the years for which he filed returns.

Appendix 2

Excerpts from Attorney General's FY'94 Tax Prosecution Unit Report

In August 1993, an individual was indicted in Suffolk Superior Court on a charge of filing a false tax return following an investigation conducted by the Tax Prosecution Unit and investigators from the Criminal Investigations Bureau of the Massachusetts Department of Revenue. That investigation revealed that the defendant derived significant income from an insurance oversight company he operated, which income he failed to report on his tax returns. Additional aspects of that investigation were conducted in connection with the Public Integrity Division which resulted in charges against the defendant's company which defrauded the City of Springfield by submitting cost control arrangement between that company and Springfield.

In August 1993, Department of Revenue investigators uncovered a scheme involving the filing of fraudulent state income tax returns and immediately referred the matter to Tax Prosecution Unit. As a result of the subsequent investigation, an individual was arrested and charged in Boston Municipal Court with larceny over $250 and charges of filing false tax returns. Further investigation conducted in conjunction with Department of Revenue investigators revealed that the arrested individual was working with an inmate at a state prison who was responsible for filing a number of false individual income tax returns. Investigation and research by the Department of Revenue allowed this office to obtain indictments against two individuals in Suffolk Superior Court on multiple charges of larceny, conspiracy and filing false tax returns. One defendant cooperated with the Commonwealth, plead guilty and was incarcerated for his role in the scheme. Charges are still pending against the second defendant, who remains incarcerated on other matters.

In February 1994, a Rochester businessman plead guilty in Suffolk Superior Court to criminal tax charges involving tax evasion, failure to account for meals taxes and failure to file corporate tax returns. The defendant failed to pay the Commonwealth approximately $240,000 in meals taxes he collected at a number of donut and coffee shops he operated. The defendant was ordered to serve two years in the House of Correction, placed on probation and ordered to perform one thousand hours of community service following his release from jail.

A South Dartmouth businessman who operated a company specializing in pre-fabricated homes was indicted on eight counts of failure to account for and pay over withholding taxes. The investigation in this case revealed that the defendant withheld taxes on approximately $1.3 million dollars in salaries paid to his employee but failed to account for and pay over such taxes to the Commonwealth. The unpaid tax liability in this case amounted to approximately $65,000.

A firefighter from Milton was indicted in Suffolk Superior Court on charges of failure to pay over sales taxes and failure to pay withholding taxes. The defendant operated a local bicycle sales and repair shop in addition to his job as a firefighter. He failed to pay over approximately $40,000 in sales and withholding taxes on approximately $750,000 of sales and wages from this bicycle business.

A husband and wife were indicted in Suffolk Superior Court on multiple counts of sales tax evasion and failure to account for and pay over sales taxes. The defendant owned and operated 14 taxicabs through seven different corporations they controlled. Tax returns filed by the couple failed to account for over $750,000 in taxicab rental fees on which the couple owed approximately $38,000 in sales taxes.

A South Hadley businessman and a corporation he owned were each indicted on one count of meals tax evasion, one count of failure to account for meals taxes and four counts of failure to file corporate excise tax returns. The investigation conducted by the Criminal Investigations Bureau of the Department of Revenue determined that the individual defendant owned a bar in Holyoke. The defendant and his corporation failed to pay approximately $35,000 in meals and excise taxes by failing to report sales to the Department of Revenue or falsely reporting the amount of such sales.

A local businessman was indicted in Suffolk Superior Court on charges that he filed false personal income tax returns in an attempt to conceal his earnings from a company he controlled. After further investigations the corporation was also indicted on a series of tax charges. The cases resulted from an investigation into a check cashing service located in Brockton. The defendant cashed account receivable checks payable to the corporation at the check cashing services's ledgers. The accountants who prepared tax returns for the corporation was not informed of the additional income and the corporate tax returns therefore were not correct. The individual defendant cashed the checks and used the receipts for his own purposes without declaring the amounts received on either the corporate or his individual tax returns.

EXHIBIT # 1

The Commonwealth of Massachusetts
Department of Revenue
Leverett Saltonstall Building
100 Cambridge Street, Boston 02204

MITCHELL ADAMS
COMMISSIONER

June 1, 1994

Mr. Thomas W. Hammond Jr.
Director
House Post Audit and Oversight Bureau
State House, Room 146
Boston, MA 02133-1053

Dear Mr. Hammond:

In your letter of May 6, you requested that the Department of Revenue provide the House Post Audit and Oversight Committee with several items of information. Your requests are repeated below in italics. To each request, my response follows:

1. *Copies of all memoranda, analysis and all other data used to prepare the tax expenditure budget for FY93, FY94, and FY95.* In each tax expenditure budget, the Department provides estimates of over 150 tax expenditures. Your request for all data and information on three annual tax expenditure budgets amounts to a request for information relating to nearly 500 estimates. The information is too voluminous to copy in whole and send to the Committee. The Department will be glad to send copies of information relating to specific estimates about which the Committee may have questions, or to provide the Committee access to the data on file for on-site inspection and copying at your convenience.

2. *Copies of all reports on non-compliance and uncollected tax revenues produced by DOR since 1985. This includes any analysis of compliance ratios or levels of compliance.* DOR's only report on compliance was written in 1987. I enclose a copy.

3. *Copies of the latest audit assessment results and projections for FY93 and FY94. Please provide breakdowns by Desk, Multistate, and Field Audit.* The following tables show audit results for the fiscal year through April and annual totals for FY93 and FY94.

Manual Audit Assessments
Year-to-Date through April and Fiscal Year Totals, FY93-FY94

FY93	Through April	FY Total
New England Audit	76,022,651	116,288,277
Desk Audit	42,326,913	48,581,039
Multistate Audit	74,129,721	86,173,205
Total	$192,479,285	$251,042,521

FY94	Through April	Projected FY Total
New England Audit	71,023,299	103,774,155
Desk Audit	49,628,302	55,264,089
Multistate Audit	59,337,846	69,998,827
Total	$179,989,447	$229,037,071

4. *Levels of auditors broken down by Desk, Multistate, and Field Audit for FY94 and FY95.*

Levels of Auditors, FY94-FY95

	FY94	Projected FY95
New England Audit	244	244
Desk Audit	75	75
Multistate Audit	51	51
Total	370	370

5. *The Boston Globe ran a two-part series relating to a potential loss to the federal treasury of $150 billion dollars. Has DOR made any similar analysis? Given that Massachusetts piggy backs on federal gross income, how much state revenue would be lost if these federal figures are accurate?* The subject of the Boston Globe series was the IRS's estimate of the federal "tax gap"—the difference between the amount of tax that should be paid and the amount collected by the Service. The Department has not made a similar analysis. The IRS study took three years to complete, at considerable expense. Only the IRS has the resources for an effort of this magnitude; we devote our compliance research to identifying pockets of noncompliance that can produce productive audit leads or nonfiler projects.

6. *You also had an article in the Boston Globe suggesting that collection of delinquent taxes was up 19% and tax refunds are sent out 28% faster. These statements are contrary to information we have received on previous occasions. Please provide us with all information used to generate these figures.* Collection of delinquent taxes by the Department has risen by 19%, from $280.2 million in FY91 to $333.5 million in FY93. This increase has been driven by growth in the amount of collections generated by the automated MASSTAX system and the automated bank levy introduced last year, as detailed in the following table.

Collection of Delinquent Taxes ($M)	FY91	FY93	% Change
Manual systems			
Gross collections (less depository payments)	$167.3	$161.4	
Automated systems			
MASSTAX	$112.9	$167.4	
Plus: Automated bank levy	0.0	4.7	
Subtotal	112.9	172.1	
Total	$280.2	$333.5	19%

As you also note, the Department's average turnaround time for processing of refund checks improved significantly during that period, from 31.2 days in FY91 to 22.6 days in FY93, 28% faster.

Sincerely,

Mitchell Adams
Commissioner of Revenue